Postal Regulatory Commission
Submitted 4/10/2012 4:26:06 PM
Filing ID: 81912
Accepted 4/10/2012

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268–0001

INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS	Docket No. RM2012-3

INITIAL COMMENTS OF THE UNITED STATES POSTAL SERVICE ON PROPOSED RULEMAKING TO EVALUATE THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS
(April 10, 2012)

In Order No. 1108, the Postal Regulatory Commission established Docket No. RM2012-3 to review the institutional cost contribution requirement for competitive products, in accordance with 39 U.S.C. § 3633(b).[1] The Commission invited public comments to inform its review. The United States Postal Service hereby provides its initial comments. As detailed below, the Postal Service recommends that the Commission (1) maintain the current requirement that the Postal Service's competitive products cover 5.5 percent of institutional costs, but (2) add a new subsection to 39 C.F.R. § 3015.7 giving the Commission the authority to find, on a case-by-case basis, that contribution below 5.5 percent meets section 3633(a)'s "appropriate share" requirement, based on the circumstances obtaining at the time of any shortfall.

I. *Maintenance of the Institutional Cost Share Framework*

Enacted in 2006 as part of the Postal Accountability and Enhancement Act (PAEA), section 3633(a)(3) requires that "all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of

[1] Order No. 1108, Notice of Proposed Rulemaking to Evaluate the Institutional Cost Contribution Requirement for Competitive Products, Docket No. RM2012-3 (Jan. 6, 2012).

the Postal Service." The Commission made this determination in Docket No. RM2007-1, by promulgating 39 C.F.R. § 3015.7, specifically subsection (c) of that rule.[2] Subsection (c) states that "the appropriate share of institutional costs to be recovered from competitive products collectively is, at a minimum, 5.5 percent of the Postal Service's total institutional costs." In adopting subsection (c), the Commission essentially made two determinations. First, it determined that the best method of implementing the section 3633(a)(3) contribution requirement was to require that competitive products cover a specified share of institutional costs. And second, it determined that the specified share should be 5.5 percent.

In making the first determination, the Commission considered a number of alternative methods, including equal unit contribution, equal percentage markup, markup over attributable costs, and percentage of revenues. In explaining its eventual choice, the Commission stated:

> To be sure, the various other methods could all be expressed mathematically in terms of percentage of total institutional costs, but each implies a pricing technique, *e.g.*, a particular coverage level, absent from simply basing appropriate share on a percentage of total institutional costs. The latter better reflects the section 3633(a)(3) directive and is more easily understood than the various alternatives.[3]

At the time, the Postal Service had recommended a markup method.[4] However, the logic of the Commission's statements above was, and remains, compelling: the Commission's method appears to be most in keeping with the plain meaning of section

[2] Order No. 43, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, Docket No. RM2007-1 (Oct. 29, 2007).
[3] Order No. 26, Order Proposing Regulations to Establish a System of Ratemaking, Docket No. RM2007-1, at ¶ 3050 (Aug. 15, 2007).
[4] Initial Comments of the United States Postal Service, Docket No. RM2007-1 (Apr. 6, 2007), at 33-34.

3633(a)(3), and it is simply understood and measured. Furthermore, over the last five years, the Postal Service has become accustomed to considering the effect of competitive product pricing decisions on the level of total institutional costs that competitive products will cover. Because the Commission's method best comports with the statute, because it is simply measured, and because parties have become accustomed to it, the Commission should not now alter it, absent some very compelling reason. Doing so could unnecessarily disrupt the Postal Service's pricing strategies and could make it difficult to compare results in coming fiscal years to results from prior fiscal years.

II. *Maintenance of 5.5 Percent Level and Grant of Commission Discretionary Authority*

As noted above, the second determination that the Commission made in adopting Rule 3015.7(c) was specifying the appropriate share of institutional costs to be 5.5 percent. As discussed below, the Commission should maintain 5.5 percent as the specified share, but it should amend Rule 3015.7(c) to grant itself the authority to find, on a case-by-case basis, that contribution below 5.5 percent meets section 3633(a)'s "appropriate share" requirement, based on prevailing circumstances.

In Docket No. RM2007-1, the Commission arrived at 5.5 percent as an appropriate share largely by reviewing the shares of institutional costs covered by competitive products in Fiscal Years 2005 and 2006 (5.4 percent and 5.7 percent, respectively).[5] The Commission stated that it was mindful, in performing this historical analysis, both of the risks to the Postal Service's flexibility that would result from setting the level too high and of the Commission's obligation to preserve competition by not

[5] Order No. 26, at ¶ 3059.

establishing the level so low as to give the Postal Service an artificial competitive advantage.[6] The Commission's statements made clear that it did not see a way to precisely quantify an appropriate share. Rather, the Commission's quantification was an act of approximation, based on balancing the two objectives noted.

It is probably uncontroversial that the Commission should not, in this docket, simply repeat the historical analysis of the shares of institutional costs covered by competitive products in previous years to determine the new appropriate competitive contribution share. While the specific analysis performed in 2007 was useful then, when the PAEA had just been enacted, it has less and less bearing as time goes on and market conditions change. More generally, Congress could not have meant "appropriate share" for each set of five fiscal years to merely mean the actual shares in the years immediately preceding such years, or it would not have directed the Commission in section 3633(b) to consider "the prevailing conditions in the market."

At the same time, it is important to recognize that the Commission's selection of a new contribution share in the instant docket will, once more, necessarily be an approximation, given the ambiguity inherent in the language of section 3633(a)(3). In making this approximation, the Commission should again be mindful both of the interest of not setting the level so high as to constrain the Postal Service's flexibility and of the interest of preserving competition by not establishing the level so low as to give the Postal Service an artificial competitive advantage. Below, the Postal Service addresses each of these interests, beginning with the latter and then turning to the former.

---

[6] *Id.*, at ¶ 3058.

Over the last five years, contribution from the Postal Service's competitive products has equaled the following shares of institutional costs:

COMPETITIVE PRODUCT CONTRIBUTION SHARES	
Fiscal Year	Contribution as a Share of Institutional Costs
2007	5.66 %
2008	5.54 %
2009	6.78 %
2010	7.12 %
2011	7.84 %

The figures for FY 2009 and FY 2011 can be considered overstated, due to the effect of legislative action in those years. Specifically, in FY 2009, Congress deferred $4 billion of the Postal Service's $5.5 billion Retiree Health Benefits Fund prefunding requirement, and in FY 2011, Congress deferred the entire $5.5 billion prefunding requirement. If Congress had not made these deferments, and instead these amounts had been considered institutional costs in FY 2009 and FY 2011, competitive products would have covered lower shares of total institutional costs in those years than presented above. The table below provides estimates of what those percentages would have been if not for the deferments:

ADJUSTED COMPETITIVE PRODUCT CONTRIBUTION SHARES	
Fiscal Year	Contribution as a Share of Institutional Costs
2007	5.66 %
2008	5.54 %
2009	5.96 %
2010	7.12 %
2011	6.61 %

Reviewing these figures, it is notable that, over the last five years, with the exception of FY 2010, the contribution of competitive products annually has been only slightly above 5.5 percent of total institutional costs. This has occurred at a time when the Postal Service's finances have been deteriorating, leading the organization to intensify its efforts to seek new and additional revenues wherever possible. On first glance, then, it appears that the 5.5 percent level is not so low as to give the Postal Service an artificial competitive advantage over its competitors.

Section 3633(b) directs the Commission, in the review being undertaken in the present docket, to consider particularly the "prevailing competitive conditions in the market." Analyzing changes in market shares among the Postal Service and its main competitors confirms the inference above that the 5.5 percent level is nowhere near low enough to give the Postal Service an artificial competitive advantage. The Postal Service has commissioned an analysis, summarized in the attached Excel workbook (MarketShareAnalysis.xls), of the competitive landscape in delivery markets over the last five years.[7] As shown in the first tab of the workbook, the Postal Service's competitors' share by volume of the overnight air delivery market increased from 95.6 percent to 96.0 percent from 2006 to 2011, while the Postal Service's share by volume of the same market decreased from 4.4 percent to 4.0 percent over the same time period. Comparing the respective shares by revenue of the same market, the Postal Service's competitors' revenue share decreased from 95.1 percent to 94.9 percent, while the Postal Service's share increased from 4.9 percent to 5.1 percent. It goes without saying that these market share changes, both by volume and revenue, are exceedingly slim. It is noteworthy that the Postal Service lost volume share but

[7] The full analysis underlying the summary workbook is being filed in library reference USPS-LR-RM2012-3/NP1. Because it contains competitive, nonpublic information, the full analysis is being filed under seal.

increased its revenue share, demonstrating that it did not at all engage in the sort of predatory underpricing that section 3633(a)(3) is intended to prevent.

The second tab of the workbook presents a similar picture for the combined domestic 2-3 day air and ground delivery market. The Postal Service's competitors' market share by volume was the same in 2006 and 2011, at 83.5 percent (although the share rose to slightly higher levels in the intervening years); the Postal Service's market share was also the same in 2006 and 2011, at 16.5 percent (though the share fell to slightly lower levels in the intervening years). Similarly, the Postal Service's competitors' market share by revenue decreased slightly from 84.1 percent in 2006 to 83.9 percent in 2011, while the Postal Service's share increased slightly from 15.9 percent to 16.1 percent over the same years. Again, these changes are remarkably small, and they make it plain that the Postal Service does not enjoy an artificial advantage over its competitors. Therefore, the Commission's choice of 5.5 percent as an appropriate contribution share has clearly satisfied the interest of not setting the share so low as to give the Postal Service an unfair advantage.[8]

Turning to the other side of the Commission's balancing exercise, it is uncertain whether the selection of 5.5 percent has satisfied the interest of not setting the level so high as to constrain the Postal Service's flexibility. To be clear, the purpose of the balancing that the Commission performed in Docket No. RM2007-1 and that it will

[8] In addition to considering the aforementioned market share analysis, it bears noting that, over the last five years, the Postal Service's competitors have not in any forum complained that the Postal Service has used its market dominant contribution to enable it to engage in predatory pricing for its competitive products. This has been the case despite the fact that the contribution requirement of section 3633(a)(3) is markedly more stringent than the antitrust standards applicable in the private sphere, where courts generally look to whether companies are pricing products below average variable costs, rather than average variable costs plus some portion of fixed costs.

perform in the instant docket is not to determine the appropriate institutional cost share *target*. Rather, the purpose is to determine the appropriate institutional cost share *floor*. The Commission elucidated this point in Docket No. RM2007-1, where it stated that, in contrast to the "reasonably assignable" requirement of the Postal Reorganization Act, the "appropriate share" requirement of the PAEA "is a floor for all competitive products, but the hope (and expectation) is that competitive products will generate contributions in excess of the floor."[9]

That the Postal Service's competitive product contribution shares have only slightly exceeded the floor in the last five years is at least circumstantial evidence that the floor is too high. Indeed, the FY 2007 and FY 2008 shares (5.66 percent and 5.54 percent, respectively) scarcely exceeded the floor. Had FY 2007 and FY 2008 competitive product revenues been slightly lower, the competitive contribution shares in those years would have been less than 5.5 percent, meaning that that the Postal Service's competitive product rates would potentially have been not in compliance with section 3633(a)(3), at a time when the Postal Service clearly did not have an artificial advantage over its competitors.

The problem of the 5.5 percent floor being too high is exacerbated by the fact that events outside of the Postal Service's control can have a significant effect on the share of institutional costs covered by competitive products. As noted above, the FY 2009 and FY 2011 shares ended up being higher than expected due to legislation enacted in those years reducing the total size of institutional costs. One can imagine other sorts of legislation that could have had the opposite effect. For example,

[9] Order No. 26, at ¶ 3056.

legislation mandating particular levels of service could enlarge the total size of institutional costs. It would seem unfair to the Postal Service that its compliance with a requirement intended to prevent an unfair competitive advantage can turn on events that have nothing to do with the Postal Service's position vis-à-vis its competitors and that are entirely outside of the Postal Service's control.

It appears, then, that the specified appropriate share should be lowered from 5.5 percent to a level that can more properly be considered a floor. However, there is one factor that militates against a significant reduction. Specifically, the Postal Service has recently transferred a few products from the market dominant product list to the competitive product list, and, over the long term, such products can be expected to increase total competitive product contribution. In addition, the Postal Service would readily acknowledge that, thus far, it has not felt that its pricing decisions have been constrained by the need to meet the 5.5 percent floor. And, as a practical matter, the Postal Service is committed to achieving as much contribution as possible from its competitive products, particularly given its current precarious financial position, and it aims to exceed the 5.5 percent floor as much as possible.

In summary, then, it appears that the 5.5 percent level is too high to properly be considered a floor, but it also appears that the 5.5 percent level has not had a detrimental effect on the Postal Service, and, more to the point, the approximate nature of the Commission's duty means that it is difficult to predetermine a regulatory floor that will accord with future conditions that are as yet unknown. Taking all of these considerations into account, the Postal Service would endorse the Commission maintaining 5.5 percent as the appropriate contribution share specified in Rule 3015.7, if the Commission modifies the rule to give itself the authority to find, on a case-by-case basis, that contribution below 5.5 percent of institutional costs is statutorily "appropriate," based on the circumstances obtaining at the time of any shortfall.[10] For example, the Commission could renumber the current subsection (c) of Rule 3015.7 as subsection (c)(1), and then add a subsection (c)(2) stating the following:

> Notwithstanding subsection (c)(1), should 5.5 percent of institutional costs not be recovered from competitive products, the Commission may determine, based on the totality of circumstances, that competitive products have nonetheless collectively covered an appropriate share of institutional costs.

Thus, if events outside of the Postal Service's control cause less than 5.5 percent of institutional costs to be recovered from competitive product contribution (and there is no surplus in the Competitive Products Fund to cover the shortfall), and if the market and subsidization concerns behind section 3633(a)(3) are not implicated, the Commission could find that competitive rates are compliant with the statute.

III. *Conclusion*

The amendment recommended by the Postal Service would better accommodate changing conditions than a new floor determined in advance, and more generally, it would lead to more rational regulation. The Postal Service appreciates the opportunity to advise the Commission in this rulemaking.

[10] It bears noting that there is presently a surplus in the Competitive Products Fund that could be applied to cover small shortfalls in future years, so the Commission's discretionary authority to find a shortfall to be statutorily appropriate would likely not be triggered in the near future, even if competitive product contribution in a particular fiscal year fails to cover 5.5 percent of that year's institutional costs.

Respectfully submitted,

UNITED STATES POSTAL SERVICE

By its attorneys:

Kevin A. Calamoneri
Managing Counsel, Corporate & Postal Business Law

Daniel J. Foucheaux, Jr.
Chief Counsel, Pricing & Product Support

Nabeel R. Cheema

475 L'Enfant Plaza, S.W.
Washington, D.C. 20260-1137
(202) 268-7178; Fax -5402
April 10, 2012